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86-781

No. ——

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

KANSAS GAS AND ELECTRIC COMPANY,
Appellant,

v.

STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS,
Appellee.

On Appeal from the Supreme Court of Kansas

JURISDICTIONAL STATEMENT

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November 14, 1986

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QUESTIONS PRESENTED

1. Whether by denying a return on 78% of the common shareholders' investment in a new power plant currently serving Kansas customers, the Kansas Corporation Commission set electric utility rates so low as to confiscate Kansas Gas and Electric Company's (KG&E) property in violation of the Fifth and Fourteenth Amendments to the United States Constitution?

2. Whether the Kansas Corporation Commission violated KG&E's rights to equal protection and due process when, for purposes of ratemaking, it valued KG&E's new power plant differently than any other power plant in Kansas?

PARTIES BELOW

The appellants in the Kansas Supreme Court were KG&E, for Case No. 58,914; Kansas City Power & Light Company, for Case No. 58,917; and Kansas Electric Power Cooperative, Inc., for Case No. 58,918. The appellee in all three cases was the State Corporation Commission of the State of Kansas (KCC).* Mary Margaret Rogers; the Attorney General of the State of Kansas; Alliance for Liveable Electric Rates; Electric Shock Coalition; City of Wichita, and Cities of Cheney, Clearwater, Derby, Garden Plain, Goddard, Kechi, Potwin and Whitewater; and Johnson County Joint Intervenor Group also participated in the appeals.

RULE 28.1 STATEMENT

KG&E has no parent and no publicly held affiliates or subsidiaries.

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* The Kansas Supreme Court consolidated the appeals of KG&E, Kansas City Power & Light Company and Kansas Electric Power Cooperative, Inc., from separate rate orders issued by the KCC. Kansas City Power & Light Company will file a separate jurisdictional statement appealing the Kansas Supreme Court decision but will use the Appendices filed by KG&E in this appeal.

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On Appeal from the Supreme Court of Kansas

JURISDICTIONAL STATEMENT

OPINIONS BELOW

The opinion of the Kansas Supreme Court (Appendix A) is reported at 239 Kan. 483, 720 P.2d 1063. The Order of the State Corporation Commission of the State of Kansas (KCC) dated September 27, 1985 (Appendix C) is reported at 70 P.U.R.4th 475. The Orders Denying Rehearing, dated November 15, 1985 (Appendix D) and November 27, 1985 (Appendix E), are unreported.

JURISDICTION

The Kansas Supreme Court issued its opinion on June 13, 1986, and denied rehearing on July 17, 1986. Kansas Gas and Electric Company (KG&E) filed timely Notice of Appeal in the Kansas Supreme Court on September 29, 1986. (App. 1i-2i). This Court has appellate jurisdiction under 28 U.S.C. § 1257(2). *See Nantahala Power & Light Company v. Thornburg*, 106 S. Ct.

2349 (1986).[1] Alternatively, this Court has jurisdiction under 28 U.S.C. § 1257(3).

CONSTITUTIONAL AND STATUTORY PROVISIONS

The United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

The United States Constitution, Amendment XIV, § 1, clauses 3 and 4:

> [N]or shall any State deprive any person of . . . property, without due process of law; nor deny to any person . . . the equal protection of the laws.

The pertinent provisions of the Kansas Public Utilities Act, K.S.A. §§ 66-101, *et seq.* are reprinted in Appendix J.

STATEMENT OF THE CASE

This is an appeal from a decision of the Kansas Supreme Court that affirmed an Order of the KCC setting electric utility rates for KG&E.[2] Those rates deny

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[1] On appeal, the Kansas Supreme Court upheld the Order of the KCC under a challenge that the Order violates KG&E's rights pursuant to the Fifth and Fourteenth Amendments to the United States Constitution. State ratemaking orders issued under delegated legislative authority are "state statutes" for purposes of 28 U.S.C. § 1257(2). *See e.g., Arkansas Elec. Coop. Corp. v. Arkansas Pub. Serv. Comm'n*, 461 U.S. 375 (1983); *Atchison, Topeka & S.F.R. Co. v. Public Utility Comm'n*, 346 U.S. 346 (1953).

[2] Rate regulation sets rates at a level that allows the utility an opportunity to earn revenues sufficient to pay operating expenses and to cover capital costs. That level of revenues typically is defined as:

Revenue Requirement = Operating Expenses + (Rate Base x Weighted Average Cost of Capital)

This appeal focuses on the rate base used by the KCC to determine the end result of the rate order, *i.e.*, KG&E's revenue requirement.

KG&E's common shareholders any return on 78 percent of that portion of their investment in the presently operating Wolf Creek Generating Station (Wolf Creek) found prudent by the KCC.[3]

KG&E provides electric utility service to 246,000 customers primarily in south central Kansas. During the 1960's KG&E relied entirely on natural gas as a fuel for generating electricity. In 1967, KG&E learned that its principal gas supplier no longer would enter into long-term gas contracts.[4] To fulfill its legal obligation to provide an adequate and reliable supply of electric power, KG&E began an orderly transition from its sole reliance on gas generation to a diversified fuel mix including coal and nuclear generation. As part of this transition, KG&E joined with Kansas City Power & Light Company (KCPL) and later with Kansas Electric Power Cooperative, Inc. (KEPCo) to construct and operate Wolf Creek—a nuclear generating plant. KG&E and KCPL each own 47% of Wolf Creek and KEPCo owns the remaining 6%.

When construction began at Wolf Creek in 1977, KG&E estimated that the project would cost approximately $1 billion. When Wolf Creek began commercial operation in 1985, the total cost was approximately $2.9 billion—below the industry average for comparable plants. The cost increased primarily due to changes in

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[3] Public utilities are entitled to a fair return on amounts prudently invested. *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 289 (1923); *see also, Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922) (regulation that goes too far constitutes a taking).

[4] This situation was not unique to KG&E, but was part of a growing national concern over the long-term supply and price of natural gas. Eventually, Congress mandated a shift away from natural gas as a boiler fuel for electric power generation in the Power Plant and Industrial Fuel Use Act of 1978.

United States Nuclear Regulatory Commission (NRC) requirements for constructing nuclear power plants.[5]

In 1984, as Wolf Creek neared completion, KG&E requested an increase in rates to reflect the addition of the plant to its rate base. KG&E calculated the increase using a rate base valued at original cost, the method used by the KCC without exception for at least the past 40 years. Accordingly, KG&E requested a rate increase of approximately $373 million to be phased-in over five years.[6] The KCC, however, granted an increase of only $169 million to be phased-in over four years. The KCC reduced KG&E's requested rate increase in three steps:

1) The KCC excluded from rate base approximately $125 million (or 10%) of KG&E's share of the construction costs because it found that those costs were imprudently incurred. (App. 46c-47c, 55c).[7] KG&E does not challenge here this finding by the KCC.

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[5] During the 1970's, several major and unexpected events occurred that led to increases in the cost of constructing nuclear power plants. In 1971, a federal court decision required nuclear plants to comply with standards set forth in the National Environmental Policy Act of 1969. *Calvert Cliffs Coordinating Committee v. Atomic Energy Comm'n*, 449 F.2d 1109 (D.C. Cir. 1971). In 1975, a fire occurred at the Tennessee Valley Authority's Browns Ferry nuclear plant and the incident at the Three Mile Island plant occurred in 1979. As a result, the NRC imposed additional licensing, design and construction requirements on nuclear plants that led to dramatic construction cost increases.

[6] To lessen the impact on its customers, KG&E requested a five year phase-in of the increase related to Wolf Creek instead of a single year increase of $373 million. This results in lower rates in the earlier years.

[7] Wolf Creek serves both retail customers whose rates are regulated by the KCC and wholesale customers whose rates are regulated by the Federal Energy Regulatory Commission (FERC). KG&E's share of the cost of Wolf Creek, regulated by the KCC is $1.295 billion. The amounts disallowed in the KCC Order are based on KG&E's total share of Wolf Creek. The amounts in this

2) Although KG&E is using its entire share of the power from Wolf Creek to provide energy to Kansas customers, the KCC found that 327 megawatts (MW) of KG&E's share of Wolf Creek's capacity is not currently needed. (App. 67c). Accordingly, the KCC excluded $716 million of costs related to 327MW of Wolf Creek. The KCC did allow a partial, deferred return on certain of those costs.[8] (App. 109c-110c). For the deferred return, the KCC valued the 327MW at $1290/kW, instead of the actual cost of $2456/kW. (*Id.*) As a result, KG&E earns no return on $305 million and only a partial (non-common equity) deferred return on $411 million of the total $716 million.

3) After the deductions for imprudence and excess capacity, the KCC found that the remaining cost of Wolf Creek was too expensive. (App. 72c). The KCC, therefore, did not use original cost to value the portion of Wolf Creek currently included in rate base but instead used a supposed "economic value" of $1290/kW, the assumed cost of a hypothetical coal plant. (App. 108c). This valuation method denies a return on an additional $194 million of KG&E's investment in Wolf Creek. The KCC did not base this valuation on a finding that KG&E had acted imprudently in building Wolf Creek. (App. 101c).

As a result of valuing Wolf Creek at $1290/kW, the KCC denied a return on $499 million of KG&E's prudent investment. The total effect of the KCC Order al-

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Jurisdictional Statement are based on KG&E's retail share of Wolf Creek. Therefore, the amounts included herein will be slightly less than the amounts in the KCC Order.

[8] The KCC allowed a deferred return on the debt and preferred stock components of KG&E's capital but not the common shareholder component. This deferred return does not affect current rates or bring KG&E any current income. The return is merely a bookkeeping entry creating a paper asset that has value only because the KCC has promised to allow KG&E to recover this amount in rates at some time in the future.

lows KG&E to earn a return on only $260 million of its $1.170 billion prudent investment in Wolf Creek, even though KG&E's entire share of Wolf Creek presently is being used to produce electricity for its customers. Because KG&E's investment in Wolf Creek is 61% of its total rate base, the KCC Order has a profound impact on KG&E.

In an application for rehearing before the KCC, KG&E alleged that the Order resulted in confiscatory rates in violation of the Fifth and Fourteenth Amendments to the United States Constitution. KG&E also argued that the manner in which the rates were set violates KG&E's equal protection and due process rights in violation of the Fourteenth Amendment to the United States Constitution. In denying rehearing, the KCC did not address directly KG&E's constitutional claims.

On appeal to the Kansas Supreme Court, KG&E argued again that the KCC Order is unconstitutional because it is confiscatory and violates KG&E's equal protection and due process rights. Nevertheless, over a strong dissent by the Chief Justice (App. 46a to 57a), the Kansas Supreme Court upheld the KCC Order.

THE QUESTIONS PRESENTED ARE SUBSTANTIAL

I. THIS CASE PRESENTS ISSUES OF NATIONAL SIGNIFICANCE

The central question in this case is whether a state constitutionally can deny the common shareholders of a utility a return on 78% of their prudent investment in an operating nuclear power plant. The answer to that question has national significance.[9] Utilities across the

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[9] The Kansas Supreme Court recognized this:

> The legal issues presented in this case are not peculiar to Kansas but are the natural result of the national controversy over the construction of nuclear power plants which has developed over the last thirty years. (App. 6a).

country have investments in over forty nuclear generating plants that are nearing completion or newly completed and awaiting final ratemaking treatment by state regulators. Those utilities have invested over $120 billion in constructing those plants. In currently pending cases, there exists a potential disallowance of tens of billions of dollars.

For plants built before the mid-1970's, low inflation, economies of scale and increases in consumer demand minimized the need for significant rate increases to recover the costs of construction. Those mitigating factors no longer exist. The cost of power plants has increased dramatically over the last ten years.[10]

Because so many utilities have invested in nuclear plants and regulators continue to limit the rate increases related to these plants, the issue presented by this case is arising more frequently and will continue to arise.[11] Absent action by this Court, the owners of new generating plants face the likelihood of the same unconstitutional disallowances that were imposed on KG&E.

A. Regulated Return—Reduced Investment Risk

Electric energy is a fundamental and pervasive part of our way of life and our economic activity. As a result, electric utilities are required by state law to provide an adequate and reliable supply of electricity on demand. *See, e.g.*, K.S.A. § 66-101b (App. 1j-2j). Electric energy in the United States is provided primarily by investor-owned utilities. These utilities finance the construction of generation, transmission and distribution facilities with investor supplied funds. Such funds are available only if utilities offer investors an opportunity to earn a return commensurate with the risk undertaken.

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[10] As discussed in Note 5, this is largely due to regulations imposed by the federal government.

[11] *See* Wall Street Journal, October 2, 1986, at 1, Col. 6.

Recent construction of new power plants throughout the country has required large amounts of funds provided by investors expecting a return on those funds. This has created a tension between the interest of consumers in low rates and the interest of investors in receiving a fair return.[12]

Regulation of rates serves to balance the interests of utility investors and ratepayers. *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

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[12] Often this tension results in consumers exerting political pressure to ensure low utility rates. This is illustrated by the Kansas legislature's efforts to limit rate recognition of Wolf Creek. In 1978, after construction of Wolf Creek began, the Kansas legislature prohibited rate recognition of the carrying costs of utility construction projects during the construction period. K.S.A. § 66-128 (App. 2j). Many states allow such rate recognition. One Kansas legislator has stated that the Kansas law is one of her proudest accomplishments. Wichita Eagle-Beacon, August 14, 1986, at 1D, Col. 1. As a result of that law, KG&E's rates were held down in the short run at the cost in the long run of adding $1 billion of accumulated and compounded carrying charges to the final cost of Wolf Creek. Such a law/public policy is not in itself unconstitutional because implicit in the policy is the "promise" that in return for the short run benefits, ratepayers will pay the long run costs in full.

As the cost of Wolf Creek increased, primarily as a result of changing NRC regulations and the Kansas law prohibiting rate recognition of construction carrying charges, the Kansas legislature became concerned about the rate impact of Wolf Creek. The "promise" that the long run costs would be paid in full was broken in 1984 when the Kansas legislature amended Kansas utility laws to facilitate reducing the rate impact of Wolf Creek. K.S.A. §§ 66-128a to 66-128k (App. 2j-9j). The principal author of the amendments described them as a response to a "political imperative." Vancrum, *The Wolf Creek Excess Cost—Excess Capacity Bill*, 33 U.Kan.L.Rev. 475 (1985). As Chief Justice Schroeder stated in his dissent from the Kansas Supreme Court decision, the legislature provided the KCC with tools sufficient to drastically reduce the rate increase related to Wolf Creek. (App. 48a). KG&E does not challenge the facial validity of the current Kansas utility statutes. KG&E challenges the KCC's unconstitutional application of those statutes. In any event, the changes in the utility law illustrate the political atmosphere in which utilities must seek rate recognition of prudent investments.

Towards that end, regulation requires utility investors to forego the opportunity to earn high returns available in competitive enterprises. In return, investors are insulated from the risk of large losses. For example, utility investors do not have the opportunity to earn the profits Ford earned on the Mustang because they do not risk the losses Ford incurred on the Edsel. Without reduced investment risk, utility investors would require higher returns. Utilities would then be unable to obtain low-cost capital to build facilities necessary to provide adequate and reliable supplies of electricity.

Since the decision in *Federal Power Commission v. Hope Natural Gas Company, supra,* regulatory commissions in Kansas and throughout the country have used original cost as the basis for determining the value of new plant added to rate base. Original cost assures that the value of additions to rate base is not subject to fluctuations in market conditions. A stable and predictable value reduces investment risk and allows utilities to attract low cost capital. Recently, however, regulators have abandoned original cost ratemaking principles.[13] The present case is an extreme example of such a departure.

In this case, the KCC adopted a new standard for valuing additions to rate base. Under the KCC standard, additional generating capacity is placed into rate base at the lesser of original cost or a supposed economic value. Existing utility assets remain valued at net original cost, which is much lower than economic value. In applying this standard, the KCC valued KG&E's new power plant —a nuclear unit—not at its original cost of $2456/kW ($2220/kW of which the KCC found prudent), but rather at $1290/kW, the supposed cost of a contemporaneous

[13] *See, e.g., Western Massachusetts Electric Co.,* Docket No. 85-270 (Mass. D.P.U., June 30, 1986); *Idaho Power Company,* Case No. U-1006-265, Order No. 20610 (Idaho P.U.C., July 11, 1986).

hypothetical coal plant. Balance suggests that this $1290/kW value be applied at least to KG&E's existing coal plants which have an original cost of much less than $1290/kW.[14]

The KCC's standard exposes utilities to the risk that new generating plant, that was prudently planned and constructed, will turn out when completed to be "uneconomical." Because economic value is applied only to new plant, a utility cannot balance the potential loss from the "uneconomical" new plant with a revaluation of existing plant. By using original cost when it is lowest and "economic value" when it is lowest, the KCC has created a situation in which a utility can only lose.

In the long run, the new valuation method applied in this case will discourage utilities from investing in needed capacity because the risk will be too great. To provide reliable service, utilities must build new power plants to replace aging facilities, meet increasing demand for electricity, and diversify the fuel sources for generating electricity. Under the new standard, investors will be unwilling to provide funds at a regulated rate of return because they have no assurance of an opportunity to earn that return. This reluctance already exists. *See Boston Edison Company*, Docket No. 85-266A at 8 (Mass. D.P.U., June 26, 1986). In that case, Boston Edison's projections showed a need for additional generating plants by 1988, but the utility had not made final plans for additional generation because it believed that recent Massachusetts rate orders make the risk of recovering investment in new plants extremely high. Before investing additional funds, Boston Edison sought assurance from the state commission that prudently incurred costs would be recoverable. Instead of providing such assurance, the Massachusetts Department of Public Utilities found that Boston Edison had abdicated its pub-

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[14] Logic would compel the use of economic value for KG&E's entire rate base.

lic service obligation and penalized the utility by reducing severely the allowed rate of return. *Id.* at 14.

The long lead time for bringing new plants into service, coupled with utilities' reluctance to invest in new capacity because of increased risk of penalties by regulators, could result in future shortages of electric power.[15]

B. The Need for Supreme Court Action

This Court is the sole federal forum available for resolving constitutional infirmities in state ratemaking proceedings. The Johnson Act, 28 U.S.C. § 1342, effectively prevents lower federal courts from reviewing state rate orders in such cases. State courts routinely refuse to review constitutional challenges to rate orders[16] and justify their refusal with their interpretation of this Court's decision in *Hope*. State regulatory commissions, therefore, operate essentially without review. Although commissions should be accorded discretion based on their ratemaking expertise, their discretion must be exercised within the bounds of the Constitution.

Until recently, this Court's lack of guidance to state regulators has not been of great concern. Questions of confiscation did not arise previously because investment in new generating plant did not represent a large portion of a utility's assets. Recent investment in new plant, however, represents vast sums, often more than one-half of rate base for many utilities. The time has

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[15] *See* Studness, *Rate Base Disallowances and Future Utility Generating Capacity*, Pub. Util. Fort., September 4, 1986, at 33.

[16] *See e.g. Legislative Utility Consumers' Council v. Public Service of New Hampshire*, 119 N.H. 332, 402 A.2d 626 (1979); *Cleveland Electric Illuminating Co. v. Public Utilities Comm'n*, 4 Ohio St. 3d 107, 447 N.E.2d 746 (1983), *appeal denied*, 464 U.S. 802 (1983); *Savannah Electric and Power Co. v. Public Service Comm'n*, 239 Ga. 156, 236 S.E.2d 87 (1977); *Washington Gas Light Co. v. Public Service Comm'n*, 450 A.2d 1187 (D.C. App. 1982); *Application of Hawaii Tel. Co.*, 689 P.2d 741 (1984).

come for this Court to provide needed guidance to state commissions about the constitutional limits on ratemaking.

This case presents the proper factual basis upon which to provide constitutional guidelines for ratemaking. Most recent requests for review by utilities claiming confiscation have involved plants not presently in service or abandoned during construction.[17] This case involves a plant that has been, and continues to be, used to provide electric power to customers in Kansas. Since Wolf Creek began commercial operation on September 3, 1985, it has produced over 8.9 billion kilowatt hours of energy, setting a United States record for nuclear plant operation. The denial of the opportunity to earn a fair return on the investment in such a plant is unconstitutional.

II. THE KANSAS COURT DECISION AND THE KCC ORDER CONFISCATE KG&E'S PROPERTY

The KCC Order as affirmed by the Kansas Supreme Court confiscates KG&E's property. By disallowing any return on 78% of the prudent investment in Wolf Creek, the KCC set rates that permit less than a one percent (0.919) return to KG&E's common shareholders.[18] The Kansas Supreme Court did not properly review the KCC Order. As a result, the rates set by the KCC and affirmed by the Kansas Court are so low that they are unconstitutional.

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[17] *See e.g., Northern Indiana Public Service Company v. Citizens Action Coalition of Indiana, Inc.*, 485 N.E.2d 610 (1985), *cert. denied*, 106 S. Ct. 2239 (1986); *Metropolitan Edison Company v. Pennsylvania Public Utility Comm'n*, 509 Pa. 32[4], 502 A.2d 130 (1985), *appeal denied*, 106 S. Ct. 2239 (1986); *Cleveland Electric Illuminating Company v. Public Utilities Comm'n*, 4 Ohio St. 3d 107, 447 N.E.2d 746 (1983), *appeal denied*, 464 U.S. 802 (1983).

[18] The KCC found that a 15.50% return to common shareholders would be reasonable. (App. 136c).

A. The Kansas Supreme Court Decision

The question presented when a rate order is challenged as confiscatory is whether the order viewed in its entirety and measured by its end result is just and reasonable. *Hope*, 320 U.S. at 602. Judicial review should focus on whether the regulator adequately has balanced investor and consumer interests and whether rates fall within the zone of reasonableness defined by those interests. *E.g., Washington Gas Light Company v. Baker*, 188 F.2d 11, 14-15 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951). This is ". . . not a standard so vague and devoid of meaning as to render judicial review a perfunctory process. It is a standard of finance resting on stubborn facts." *Colorado Interstate Gas Company v. Federal Power Commission*, 324 U.S. 581, 605 (1945). The reviewing court must determine whether the rate order provides enough revenue not only for operating expenses, but also for capital costs of the business, including service on debt and dividends for stockholders. The return on equity must be commensurate with returns available from enterprises having similar risks and must be sufficient to assure confidence in the financial integrity of the utility in order to attract capital and maintain credit ratings. *Hope*, 320 U.S. at 603.

The Kansas Supreme Court ostensibly recognized its obligation to ensure that the KCC "establish a rate within the 'zone of reasonableness' after application of a balancing test in which the interests of all concerned parties are considered." (App. 45a). Nevertheless, that court's opinion demonstrates that it did not perform any review to determine whether the KCC in fact achieved that goal. The court's *entire* discussion of the reasonableness of the KCC Order is contained in a scant two paragraphs. (App. 45a-46a). Nowhere in those two paragraphs did the court consider whether the order provides sufficient revenue for the capital costs of the business, whether the return allowed is commensurate with

returns on investments with comparable risks, and whether the return is sufficient to maintain credit and attract capital—the investors' interests defined in *Hope*. 320 U.S. at 603.

By ignoring the consequences of the KCC Order on KG&E's investors, the Kansas Supreme Court did not apply the standard of review required by *Hope*. The court's only inquiry into the financial consequences of the KCC Order led it to the conclusion that the rates were not improper because "[i]t is only the return or profit on certain costs which has been restricted by the Commission." (App. 46a). The "restriction of return" is exactly what must be examined in a constitutional inquiry. The Kansas Supreme Court did not perform such an examination. If the court had applied the proper standard of review, the only possible conclusion would have been that the restriction of a return on KG&E's investment in 61% of its total utility property is unconstitutional.

B. The KCC Order

The rates set by the KCC are so low that they are constitutionally deficient. The KCC must have known this. In its Order, the KCC noted that the first-year rate increase proposed by KG&E was the minimum amount that would meet KG&E's financial requirements. (App. 151c). The KCC also found that an alternative rate increase proposed by the KCC Staff (which was lower than KG&E's request) would place KG&E under "severe financial stress." (App. 155c). The KCC went on to note that the rate increase actually adopted "will have an even more serious impact on the company's financial health." (*Id.*) Rates below those that create severe financial stress and below those that meet minimum financial requirements necessarily deny investors an opportunity for a fair return on their investment and result in confiscation.

Investors must be allowed the opportunity to earn revenues sufficient to cover operating expenses and capital costs, including debt service and dividends on stock. *Hope*, 320 U.S. at 603. The revenues allowed by the KCC do not meet the requirements of *Hope*. Deductions from KG&E's rate base related to Wolf Creek result in KG&E being authorized to earn annual net operating income of approximately $120.8 million [19] by the end of the four year rate phase-in. From that operating income, KG&E must pay interest on its mortgage bonds, bank loans and other contractually established credit agreements, as well as dividends on preferred stock. At the time of KG&E's rate case, those commitments amounted to approximately $114.4 million. That leaves only $6.4 million per year to cover any increases in operating expenses during the phase-in period and to provide a return for KG&E's common shareholders. If KG&E's shareholders were to receive the entire $6 million (which is highly unlikely), they would earn less than a one percent return.[20]

The KCC found that a 15.50% return to common shareholders would be reasonable for KG&E. (App. 136c). But by imposing the rate base disallowances, the KCC denied KG&E the opportunity to earn that return on its prudent investment. The Federal Energy Regulatory Commission's benchmark rate of return of 13.96% for electric utilities at the time the KCC Order was issued also is greater than the return KG&E received. 50 Fed. Reg. 29655 (July 22, 1985). Less than a one percent return hardly can be characterized as commensurate with returns on investments in enterprises having comparable risks and thus confiscates KG&E's property.

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[19] This amount is based on the total rate increase of $169 million allowed by the KCC. The increase allowed in the first year of the phase-in, however, is only $135 million.

[20] That return increases to only 2.940% by recognizing the KCC's allowance of a partial (*i.e.*, no return on common equity), non-current non-cash return on the portion of Wolf Creek found to be excess physical capacity. (*See supra* page 5).

III. THE KCC'S METHOD OF SETTING RATES VIOLATES KG&E'S RIGHT TO EQUAL PROTECTION AND DUE PROCESS

A. The KCC Denied KG&E Equal Protection

The KCC's charge under K.S.A. § 66-128 is to determine the "reasonable value" of all property used and required to be used to serve the public in Kansas. (App. 14a). The KCC has consistently applied this statute, existing in substantially similar form since 1911, by using a single measure of value for all utility assets. The KCC deviated from this long-standing practice in determining the value of Wolf Creek. In calculating KG&E's rates, the KCC used the supposed "economic value" of Wolf Creek—a value significantly below original cost. The KCC applied this measure of value only to Wolf Creek. KG&E's other assets remain valued at net original cost, which is far below their "economic value." The valuation method used by the KCC is inherently punitive because it ensures that the lowest possible value is applied to a utility's property. When "economic value" is lower, the KCC uses that method; when original cost is lower, the KCC uses original cost. In his dissent, Chief Justice Schroeder recognized the impropriety of this inherently punitive valuation method:

> A regulatory body may not arbitrarily use the asserted, lower cost of a fictional facility instead of the historical cost of an actual facility in assigning a value to the facility in question for rate base purposes, particularly where that is done selectively to achieve the lowest possible rate base.

(App. 56a).

Application of this special ratemaking treatment to KG&E and not other Kansas utilities, and application of the method only to Wolf Creek and not KG&E's other assets so lacks a rational basis that the KCC Order fails to meet the minimal standard of rationality required for equal protection under the Fourteenth Amendment. *See*

New Orleans v. Dukes, 427 U.S. 297, 303 (1976). The KCC articulated no justification for this denial of equal treatment. Although KG&E repeatedly demonstrated that the KCC Order failed to meet the minimal standard of rationality required for equal protection, the Kansas Supreme Court never addressed KG&E's arguments.[21]

The KCC's determination of a "reasonable value" for KG&E's utility property in this case is the product of an arbitrary and capricious decision-making process. The concept of "reasonable value" is not so malleable and imprecise that it allows inconsistent valuation methods for KG&E's generating plants, especially when all of KG&E's plants produce an identical product—electricity. In other utility ratemaking cases where mixed measures of value have been proposed, in the guise of economic excess capacity or otherwise, regulatory bodies and courts have consistently rejected the proposal.[22] This Court likewise should reject the imposition of inconsistent valuation methods. An affirmance of the decision challenged in this appeal will sanction an unconstitutional practice and send the economic signal of increased investment risk to every utility shareholder in the country.

B. The KCC Denied KG&E Procedural Due Process

In addition to violating KG&E's right to equal protection, the KCC violated KG&E's right to procedural due

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[21] The Kansas Supreme Court did not separately address KG&E's equal protection and due process claims. Uncertainty exists about whether the standard of review set forth in *Hope* applies only to questions of confiscation or whether the standard applies to all challenges to rate orders. Review by this Court is appropriate to clarify the confusion about the standard for judicial review of rate orders.

[22] *See, e.g., Montana Power Co. v. Montana Department of Public Service Regulation*, 68 P.U.R.4th 521, 526-27 (Mont. Dist. Ct. 1985); *Washington Water Power Co.*, 60 P.U.R.4th 503, 508-9 (Idaho P.U.C. 1984); *Union Electric Co.*, 67 P.U.R.4th 218, 233 (Ill. C.C. 1985); *Union Electric Co.*, 72 P.U.R4th 444, 450 (Iowa CC. 1986); *Long Island Lighting Company*, 75 P.U.R.4th 423, 457 (N.Y.P.S.C. 1986).

process.[23] Using the assumed cost of a hypothetical coal plant as the basis for valuing Wolf Creek was not even discussed at the hearings before the KCC. This valuation method first appeared in the KCC Order. KG&E had no opportunity to present evidence about the propriety of using the cost of an alternative generating plant to value Wolf Creek or, assuming that such a method were proper, the appropriate costs to include in such a computation. KG&E was completely surprised by the KCC's creation of such a valuation method. KG&E has been deprived of its rights to notice and an opportunity to be heard on this issue.

KG&E had a hearing on its rate request, but as to the measure of value adopted by the KCC for Wolf Creek, the deprivation of notice and an opportunity to be heard was complete. The valuation of Wolf Creek was the most important issue before the KCC. KG&E, therefore, should not be foreclosed from presenting evidence or challenging through cross-examination the valuation method under consideration and ultimately adopted by the KCC.

Protection of KG&E's right to procedural due process takes on even greater significance in light of the substantial departure from past regulatory practice adopted by the KCC and approved by the Kansas Supreme Court. Following this Court's decision in *Hope*, regulators, including the KCC, valued rate base at the net original cost of a utility's investment. Indeed, the Kansas Supreme Court adopted this traditional definition when it defined rate base:

> The 'rate base' may be defined as the dollar amount of a given utility's *investment* in the plant and property 'used and required to be used' in supplying the service that the utility has undertaken to furnish.

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[23] There can be no question of KG&E's right, under the Fourteenth Amendment, to procedural due process in ratemaking proceedings before the KCC. *See Railroad Comm'n v. Pacific Gas & Electric Co.*, 302 U.S. 388, 393 (1938).

(App. 27a (emphasis added)). The KCC abandoned net original cost as the measure of Wolf Creek's value. As noted by Chief Justice Schroeder in his dissent, "[t]he [valuation] method used by the KCC . . . was the unprecedented revaluation of the Wolf Creek facility . . . as a hypothetical coal plant." (App. 51a). Such a departure from past regulatory practice in Kansas and across the country warrants notice and an opportunity to be heard. Both were absent in the proceeding before the KCC and both are unaddressed by the Kansas Supreme Court.

CONCLUSION

The Court should note jurisdiction and set the case for full briefing and argument on the merits. Regulators of electric utilities are sorely in need of guidance. The constitutional questions concerning the ability of utilities to provide electric power are too important to allow state regulators and courts to be the only tribunals to consider them. Therefore, this Court should reverse the Kansas Supreme Court decision and remand the case with instructions to set phased-in rates for KG&E reflecting the full prudent costs of Wolf Creek.

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